Summary of Testimony of
Cynthia A. Marlette
Deputy General Counsel
Federal Energy Regulatory Commission
Before the Subcommittee on Securities and Investment
Of the Committee on Banking, Housing and Urban Affairs
United States Senate
March 29, 2001

S. 206, the "Public Utility Holding Company Act of 2001," provides an important piece of the legislative reform that is needed to support the nation's emerging competitive electric energy markets. At this critical stage in the evolution of the electric industry, it is important to take all reasonable measures to support the development of competitive energy markets and to provide appropriate incentives for electric and natural gas infrastructure to meet our nation's energy needs. However, such measures must ensure adequate protection of electric and natural gas ratepayers from abuse of market power and inappropriate affiliate cross-subsidization. Repeal or reform of the Public Utility Holding Company Act (PUHCA), such as that contained in S.206, will help accomplish these objectives, whether as part of a comprehensive energy legislative package or on a stand-alone basis.

While one of the goals of PUHCA was to protect against corporate structures that could harm investors and ratepayers, today some of PUHCA's restrictions may actually impede competitive markets and appropriate competitive market structures, to the detriment of ratepayers and shareholders in the long run.

PUHCA should be repealed or reformed, so long as the following matters are addressed. First, Congress should ensure that the Federal Energy Regulatory Commission (FERC) and state regulatory authorities have adequate access to the books and records of all members of all public utility holding company systems when that information is relevant to their statutory ratemaking responsibilities. Second, any exemptions from a new holding company act should be crafted narrowly. While it may be appropriate to grandfather previously authorized activities or transactions, no holding company should be exempt from affiliate abuse oversight.

S. 206, as introduced on January 30, 2001, adequately addresses the above concerns with respect to the protection of electric and natural gas ratepayers. Further, as a general matter, enactment of the bill would help promote competitive and regional solutions to problems facing today's electric energy markets, to the long run benefit of consumers.

Testimony of
Cynthia A. Marlette
Deputy General Counsel
Federal Energy Regulatory Commission
Before the Subcommittee on Securities and Investment
Of the Committee on Banking, Housing and Urban Affairs
United States Senate
March 29, 2001

Mr. Chairman and Members of the Subcommittee:

Good morning. My name is Cynthia A. Marlette, and I am Deputy General Counsel of the Federal Energy Regulatory Commission (FERC). Thank you for the opportunity to appear here today to discuss the Public Utility Holding Company Act of 1935 (PUHCA) and S. 206, which would repeal the 1935 Act and replace it with a streamlined act. I appear today as a Commission staff witness, and do not speak on behalf of the Commission or any Commissioner.

As I will discuss further in my testimony, S. 206 provides an important piece of the legislative reform that is needed to support the nation's emerging competitive electric energy markets. At this critical stage in the evolution of the electric industry, it is important to take all reasonable measures to support the development of competitive energy markets and to provide appropriate incentives for electric and natural gas infrastructure to meet our nation's energy needs. However, such measures must ensure adequate protection of electric and natural gas ratepayers from abuse of market power and inappropriate cross-subsidization. Repeal or reform of PUHCA, such as that contained in S.206, will help accomplish these objectives, whether as part of a comprehensive energy legislative package or on a stand-alone basis.

This is a time of enormous change for the electric utility industry. We are at a critical juncture in the development of competitive power markets, and it is appropriate for the Congress to reexamine the framework for regulating electric utilities, including unnecessary restrictions that PUHCA places on the activities of certain participants in these power markets. While one of the goals of PUHCA was to protect against corporate structures that could harm investors and ratepayers, today some of PUHCA's restrictions may actually impede competitive markets and appropriate competitive market structures, to the detriment of ratepayers and shareholders in the long run.

Since the Banking Committee's hearings on an earlier version of PUHCA repeal legislation were held in 1996, the FERC and many state regulators and state legislatures have continued regulatory actions to support and encourage the development of competitive power markets at both the wholesale and retail levels. Many areas of the country, such as Pennsylvania, have been very successful. However, there have been some bumps in the road. In particular, California's experience with only a partially deregulated electric generation market and a severe lack of adequate generation supply and transmission infrastructure in that state have grabbed media attention nationwide. This has caused some regulators and industry observers to become wary of the promised virtues of competition in the electric industry. There is no doubt that California and the West face serious, complex electric power supply and pricing issues. Nevertheless, while regulators and industry participants may disagree on near-term remedies to address the dysfunctions in California and Western power markets, the majority of industry observers continue to believe that competitive power markets, as opposed to traditional cost-based regulation, will best serve consumers in the long run.

In past testimony, FERC witnesses have raised no objection to repeal or reform of PUHCA, so long as certain ratepayer issues are addressed. Today, we continue to take the position that PUHCA needs to be repealed or reformed, so long as the following matters are addressed:

- First, Congress should ensure that the FERC and state regulatory authorities have adequate access to the books and records of all members of all public utility holding company systems when that information is relevant to their statutory ratemaking responsibilities. This is necessary to prevent affiliate abuse and subsidization by electricity ratepayers of non-regulated activities of holding companies and their affiliates.
- Second, any exemptions from a new holding company act should be crafted narrowly. While it may be appropriate to grandfather previously authorized activities or transactions, no holding company should be exempt from affiliate abuse oversight.
- Third, if Congress transfers any existing PUHCA functions to the FERC, instead of repealing PUHCA in its entirety, Congress needs to provide FERC with staff and administrative support necessary for us to carry out the additional responsibilities.

S. 206, as introduced on January 30, 2001, adequately addresses the above concerns.

Background

Under current law, the two major federal statutes affecting electric utilities are PUHCA and the Federal Power Act (FPA). Both statutes were enacted as part of the same legislation in 1935 to curb widespread financial abuses that harmed electric utility investors and electricity consumers. While there is overlap in the matters addressed by these Acts, they each have different public interest objectives. The areas of overlap in the two statutes, and specific issues raised if PUHCA is repealed or amended, are described in detail in the Attachment to my testimony. As a general matter, however, the Securities and Exchange Commission (SEC) regulates registered public utility holding companies under PUHCA while FERC, under the FPA, regulates the operating electric utility and gas pipeline subsidiaries of the registered holding companies. The agencies often have responsibility to evaluate the same general matters, but from the perspective of different members of the holding company system and for different purposes. The FERC focuses primarily on a transaction's effect on utility ratepayers. The SEC focuses primarily on a transaction's effect on corporate structure and investors.

In June 1995, the SEC issued a report entitled “The Regulation of Public-Utility Holding Companies” and recommended that Congress conditionally repeal PUHCA and enact certain ratepayer safeguards in its place. We agree with a fundamental premise of the SEC’s report that rate regulation at the federal and state levels has become the primary means of ensuring ratepayer protection against potential abuse of monopoly power by utilities that are part of holding company systems.

Further, we believe that PUHCA, in its current form, may actually encourage market structures that impede competition. In particular, under PUHCA acquisitions by registered holding companies generally must tend toward the development of an "integrated public-utility system." To meet this requirement, the holding company's system must be "physically interconnected or capable of physical interconnection" and "confined in its operations to a single area or region." This requirement tends to result in geographic concentrations of generation ownership, which may enhance market power and diminish competition.

In addition, PUHCA may cause unnecessary regulatory burdens to utilities who, in compliance with Commission policy and regulations, seek to form or join regional transmission organizations (RTOs). It is RTOs that will provide the major structural reform needed in the electric industry to ensure mitigation of market power and an efficient, reliable transmission system. These institutions will operate, or both own and operate, the interstate transmission grid within their regions, provide transmission services on an open, non-discriminatory basis, and provide the means for regional transmission planning. They may be non-profit independent system operators (ISOs), or they may be for-profit transmission companies (transcos), or a combination of the two. The cornerstone requirement for the institutions, however, is that they be independent from power market participants, i.e., independent from those that own, sell or broker generation. Under PUHCA, any entity that owns or controls facilities used for the transmission of electric energy - such as an RTO - falls within the definition of public utility company, and any owner of ten percent or more of such a company would be a holding company and potentially could be required to become a registered holding company. This could serve as a significant disincentive for investments in independent for-profit transcos that qualify as RTOs.

Review of S. 206

S. 206 would repeal PUHCA and, in its place, enact the Public Utility Holding Company Act of 2001. The new Act would do five major things:

- provide the FERC with access to books and records of holding companies and their associate and subsidiary companies, and of any affiliates of holding companies or their subsidiaries (section 5);
- give state commissions that have jurisdiction over a public utility in a public utility holding company system access to books and records of a holding company, its associates or affiliates (section 6);
- require the FERC to promulgate a final rule, no later than 90 days after enactment, to exempt from the books and records access requirements of section 5 any person that is a holding company solely with respect to one or more: qualifying facilities under the Public Utility Regulatory Policies Act of 1978; exempt wholesale generators; or foreign utility companies (section 7);
- provide that nothing in the Act precludes the FERC or a state commission from exercising its jurisdiction under otherwise applicable law to determine whether a public utility may recover in rates any costs of an activity

performed by an associate company, or any costs of goods or services acquired from an associate company (section 8); and

- grandfather activities in which a person is legally engaged or authorized to engage on the effective date of the new act (section 9).

With these protections in place, and with the Commission's other regulatory authorities under the FPA in place, we believe that S. 206 is an appropriate vehicle for repealing PUHCA without impairing ratepayer protection.

If PUHCA is not repealed, Congress should address the Ohio Power regulatory gap created by a 1992 court decision. In a decision by the United States Court of Appeals for the District of Columbia Circuit, Ohio Power Company v. United States, 954 F.2d 779 (D.C. Cir. 1992), the court held that if a public utility subsidiary of a registered holding company enters into a service, sales or construction contract with an affiliate company, the costs incurred under that affiliate contract cannot be reviewed by FERC. The court reasoned that because the SEC has to approve the contract before it is entered into, FERC cannot examine the reasonableness or prudence of the costs incurred under that contract. FERC must allow the costs to be recovered in wholesale electric rates, even if the utility could have obtained comparable goods or services at a lower price from a non-affiliate.

The Ohio Power decision has left a gap in rate regulation of electric utilities. The result is that utility customers served by registered holding companies have less rate protection than customers served by non-registered systems. If PUHCA is repealed, as in S. 206, this issue becomes moot. If the contract approval provisions of PUHCA are retained, however, this regulatory gap should be closed to restore FERC's ability to regulate the rates of utilities that are members of registered holding company systems.

In summary, S. 206 provides an appropriate means to help promote emerging competitive electric power markets while at the same time providing the FERC and states additional access to books and records in order to protect consumers against inappropriate cross-subsidization and market power abuse. Thank you again for the opportunity to be here today, and I would be happy to answer any questions you may have.

ATTACHMENT
TESTIMONY OF CYNTHIA A. MARLETTE
MARCH 29, 2001

Existing Statutory Framework: FERC/SEC Jurisdiction

The FERC's primary function under the FPA is ratepayer protection. The FERC regulates public utilities as defined in the FPA. These include individuals and corporations that own or operate facilities used for wholesale sales of electric energy in interstate commerce, or for transmission of electric energy in interstate commerce. The FERC does not regulate all utilities. For example, publicly-owned utilities and most cooperatives are exempt from our traditional rate regulatory authority.

The FERC ensures that rates, terms and conditions for wholesale sales of electric energy and transmission are just, reasonable and not unduly discriminatory or preferential. In addition, the FERC has responsibilities over corporate mergers and other acquisitions and dispositions of jurisdictional facilities, transmission access, certain issuances of securities, interlocking directorates, and accounting. In exercising its responsibilities, the Commission must take into account any anticompetitive effects of jurisdictional activities.

There is overlap in the jurisdiction of the FERC and the SEC. As a general matter, the SEC regulates registered utility holding companies whereas the FERC regulates the operating electric utility and gas pipeline subsidiaries of the registered holding companies. The agencies often have responsibility to evaluate the same general matter, but from the perspective of different members of the holding company system and for different purposes. The FERC primarily focuses on the impact of a transaction on utility ratepayers. The SEC, on the other hand, primarily focuses on the impact of a transaction on corporate structure and investors.

There are four major areas of overlap in the jurisdiction of the FERC and the SEC with respect to regulation of the electric industry:

(1) Accounting - The SEC has authority to establish accounting requirements for every registered holding company, and every affiliate and subsidiary of a registered holding company. Many of these companies are public utilities that are also under the FERC's jurisdiction and subject to its accounting requirements.

(2) Corporate regulation - The SEC must approve the acquisition of a public utility's securities by a registered holding company. The FERC must approve the disposition or acquisition of jurisdictional facilities by a public utility.

(3) Rates - The SEC must approve service, sales and construction contracts among members of a registered holding company system. The FERC must approve wholesale rates reflecting the reasonable costs incurred by a public utility under such contracts.

(4) PUHCA Exemptions - Under the PUHCA section 32 amendment contained in the Energy Policy Act of 1992, the FERC must determine whether an applicant meets the definition of exempt wholesale generator, and thus is exempt from the Holding Company Act. With minor exceptions, the SEC continues to make PUHCA exemption determinations under the pre-Energy Policy Act PUHCA provisions as well as under the new section 33 of PUHCA (concerning foreign companies).

Congress recognized the overlap in FERC-SEC jurisdiction when it simultaneously enacted PUHCA and the FPA in 1935. It included section 318 in the FPA, which provides that if any person is subject to both a requirement of the FPA and PUHCA with respect to certain subject matters, only the requirement of PUHCA will apply to such person, unless the SEC has exempted such person from the requirements of PUHCA. If the SEC has exempted the person from the PUHCA requirement, then the FPA will apply.

During the half-century following enactment of PUHCA and the FPA, there were no significant problems resulting from the overlap in FERC-SEC jurisdiction, until a series of court decisions involving the wholesale rates of the Ohio Power Company. Under the last of these court decisions, a 1992 decision by the United States Court of Appeals for the District of Columbia Circuit (Ohio Power Company v. FERC, 954 F.2d 779 (D.C. Cir. 1992) (Ohio Power)), the FERC does not have the extent of rate jurisdiction which it previously thought it had over public utility subsidiaries of registered electric utility holding companies.

Under the 1992 Ohio Power decision, if a public utility subsidiary of a registered holding company enters into a service, sales or construction contract with an affiliate company, the costs incurred under that affiliate contract cannot be reviewed by the FERC. The SEC has to approve the contract before it is entered into. However, the FERC cannot examine the reasonableness or prudence of the costs incurred under that contract. The FERC must allow those costs to be recovered in wholesale electric rates, even if the utility could have obtained comparable goods or services at a lower price from a non-affiliate.

This decision has left a major gap in rate regulation of electric utilities. The result is that utility customers served by registered holding companies have less rate protection than customers served by non-registered systems. If PUHCA is repealed, the Ohio Power problem goes away. This is a significant advantage of S. 206, introduced January 30, 2001. S. 206 would repeal PUHCA and enact a new, more limited law that does not give rise to an Ohio Power problem. Short of repeal of PUHCA, however, the existing regulatory gap needs to be addressed.

Issues Raised If PUHCA Is Repealed or Amended

There are several ratepayer protection issues on which Congress should focus in considering PUHCA legislation. S. 206 adequately addresses these issues.

An important aspect of ratepayer protection is preventing affiliate abuse and the subsidization by ratepayers of the non-regulated activities of non-utility affiliates. These issues can arise in virtually every area of the FERC's responsibilities. In the case of public utilities that are members of holding companies, there are increased opportunities for abuses. There are several reasons for this.

First, registered holding companies have centralized service companies that provide a variety of services (e.g., accounting, legal, administrative and management services) to both the regulated public utility operating companies in the holding company system, and to the non-regulated companies in the holding company system. The FERC's concern in protecting ratepayers is that when the costs of these service companies are allocated among all members of the holding company system, the ratepayers of the public utility members bear their fair share of the costs and no more; ratepayers should not subsidize the non-regulated affiliates of the public utilities.

Thus far, FERC has had few, if any, problems with inappropriate allocations of service company costs. The services provided by the centralized service companies have been relatively limited. In recent years, however, there has been a substantial increase in the services being performed by these types of service company affiliates. In many registered company systems, the majority of the costs of operating and maintaining the operating utilities' systems, which previously were incurred directly by each individual utility, are now being incurred by the service company and billed to the public utility under SEC-approved allocation methods. These costs can be significant for ratepayers. This means that rate regulatory oversight of service company allocations is imperative.

A second concern involves special purposes subsidiaries. In addition to the centralized service companies, registered holding companies increasingly are forming special purpose subsidiaries that contract with their public utility affiliates to supply services, as well as goods and construction. This can include fuel procurement, services such as operation of power plants, telecommunications, and construction of transmission lines and generating plants.

The FERC's primary concern with affiliate contracts for goods and services is that utilities not be allowed to flow through to electric ratepayers the costs incurred under affiliate contracts if those costs are more than the utility would have incurred had it obtained goods or services from a non-affiliate. As discussed earlier, under the 1935 PUHCA the FERC cannot provide adequate protection to ratepayers served by registered systems because of the 1992 Ohio Power court decision.

The Commission recently has made some progress in protecting customers served by registered holding companies by using its conditioning authority over registered holding company public utilities that seek approval to sell power at market-based rates. The Commission has said that if such utilities want to sell at market-based rates, they must agree not to purchase non-power goods and services from an affiliate at an above-market price; they must agree that if they sell non-power goods and services to an affiliate, they will do so at the higher of their cost or a market price. However, the Commission's market rate conditioning authority is not enough to protect all registered system ratepayers against abusive affiliate contracts. Short of repeal of PUHCA, legislation is needed to fully remedy the regulatory gap.

According to the SEC's 1995 report, service companies render over 100 different types of services to the operating utilities on their systems, with non-fuel transactions aggregating approximately $4 billion annually. This growth adds to the potential for ratepayer subsidies involving both the centralized and the special-purpose service companies.

Another reason for heightened concern regarding affiliate abuses in all holding company systems, both registered and exempt, is the large number of holding company subsidiaries that engage in non-utility businesses. According to the SEC report, since the early 1980's the number of non-utility subsidiaries of registered companies has quadrupled to over 200. The trend in exempt companies is also likely to be significant as well. The sheer number of non-utility business activities brings greater potential for improper allocation of centralized service company costs to the non-utility businesses (i.e., electric ratepayers subsidizing the non-utilities' fair share of the costs). It also increases the opportunities for affiliate contracting abuses.

To protect against affiliate abuse and cross-subsidization, federal and state regulators must have access to the books, records and accounts of public utilities and their affiliates. Under section 301 of the FPA (and section 8 of the Natural Gas Act), the FERC has substantial authority to obtain such access. It can obtain the books and records of any person who controls a public utility, and of any other company controlled by such person, insofar as they relate to transactions with or the business of the public utility. This, however, may not necessarily reach every member of the holding company. Thus far, there has been no significant problem in obtaining access to books and records and in monitoring and protecting against potential abuses. However, the SEC's regulatory role with respect to registered systems has been an added safeguard.

It is critical that both state and federal regulators have access to books and records of all companies in a holding company system that are relevant to costs incurred by an affiliated utility. This is equally true with respect to both registered and exempted holding company systems. If Congress modifies or repeals PUHCA, it should clearly confirm the FERC's mandate and authority to ensure that ratepayers are protected from affiliate abuse. Similarly, we encourage Congress to be mindful of concerns expressed by state commissions and provide states with appropriate access to relevant books and records of all holding company systems.

In addition to the above ratepayer protection concerns, there are several other matters that should be considered in analyzing PUHCA reform. These include future corporate structures in the electric industry, diversification activities, and the issuances of securities affecting public utilities.

As mentioned earlier, the FERC must approve public utility mergers, acquisitions, and dispositions of jurisdictional facilities. This is an area in which the Commission has overlapping jurisdiction with the SEC, but also an area in which in some instances there is no overlap. Jurisdictional facilities under the FPA are facilities used for transmission in interstate commerce, or for sales for resale in interstate commerce. FERC has claimed jurisdiction over transfers of jurisdictional sales contracts but has disclaimed jurisdiction over dispositions that solely involve physical generation facilities. It appears that state regulators have adequate authority to regulate dispositions of physical generation assets. Further, such dispositions or acquisitions would be subject to the antitrust laws.

The FERC does not have jurisdiction to approve or disapprove diversification activities of public utilities or holding companies. Thus, if PUHCA were repealed, there would be no federal oversight of diversification activities of registered holding companies or their public utility members, other than through FERC auditing of books and records. However, the SEC does not directly review public utility diversification activities of other holding companies and public utilities, and this has not posed any significant problems in the FERC's protection of ratepayers. In addition, many state commissions regulate diversification by public utilities that sell at retail.

A final area involves issuances of securities. The FERC must approve issuances of securities by public utilities that are not members of registered holding company systems, unless their security issuances are regulated by a state commission. Because the majority of states regulate issuances by public utilities, the FERC does not regulate most public utilities' issuances. If PUHCA were repealed, it appears that there would be no federal review and approval of issuances of securities by holding companies or their public utility members. The SEC can more appropriately address whether any federal oversight is necessary in this area.